No. 17352

In the United States Court of Appeals for the Ninth Circuit

THE FARMERS UNION CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 254–295) are not officially reported.

JURISDICTION

This petition for review involves federal income taxes for the calendar years 1951, 1952 and 1953. On June 20, 1957, the Commissioner of Internal Revenue mailed to taxpayer a notice of deficiency for those years in the respective amounts of $22,309.36, $4,830.95, and $7,676.72, for a total amount of $34,817.03. (R. 5–6.) Within ninety days thereafter (*viz,* on September 3, 1957) the taxpayer filed in the

Tax Court its petition for redetermination of those deficiencies under the provisions of Section 272(a) of the Internal Revenue Code of 1939. (R. 3, 5–8.) The decision of the Tax Court finding deficiencies of $22,309.36, $4,800.95 and $7,647.91 (aggregating $34,758.22) for the years 1951, 1952 and 1953, respectively, was entered on October 25, 1960. (R. 299.) Within three months thereafter (*viz,* on January 19, 1961), taxpayer petitioned for review. (R. 300–301.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the court below properly found that where the taxpayer segregated its mercantile business from its real property business and distributed the former to a partnership comprised of seven of its shareholders in exchange for shares of its capital stock, the distribution was a partial liquidation rather than a sale and therefore taxpayer did not realize any loss on the transaction.

2. Whether even assuming that the distribution of the mercantile business was made pursuant to a sale rather than a liquidation, there was no recognizable gain or loss from the exchange since the transferees own more than 50% of taxpayer's stock.

3. Whether taxpayer failed to satisfy its burden of proof as to the fair market value of the capital stock received by it and therefore failed to demonstrate that in fact it suffered any loss.

4. Whether the Tax Court properly determined that certain expenditures of taxpayer for legal and ac-

counting services incident to the distribution in partial liquidation were capital expenses.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra.*

STATEMENT

The relevant facts as found by the Tax Court are as follows:

Taxpayer, a California corporation, was organized in the year 1874 and since that date has operated its business in San Jose, California. (R. 257.) For many years, the primary business of taxpayer was the operation of a general country store which sold numerous varieties of items, e.g., groceries, household wares, paints, gardening tools and builders' hardware. As time went on, taxpayer also became engaged in the real estate business, owning, among other properties, the land and building from which its business was conducted. The upper part of that building was leased as a hotel. (R. 258.)

During the early years of taxpayer's business, San Jose was a small community serving farmers in the Santa Clara valley. As San Jose grew into a substantial city, taxpayer's competition increased and consequently changes were made in its mercantile business. The operation of some of the departments in its store became unprofitable and in 1940, taxpayer closed its grocery and meat departments and limited its mercantile business to hardware. (R. 258.)

Even after that contraction, the directors and shareholders of taxpayer were concerned about the operation of a mercantile business. From about 1945 to 1951, taxpayer's president considered selling the mercantile business, but no specific offer was ever received by taxpayer or considered by its directors. (R. 260–261.)

In 1950, taxpayer's directors proposed that a new corporation be formed and that taxpayer's real estate business be "spun off" to the new corporation in return for the latter's stock which was then to be distributed to taxpayer's shareholders. The shareholders approved this plan, but it was never executed.[1] (R. 261–262.)

On May 17, 1951, McEnery, taxpayer's president, submitted to the directors a plan for the segregation of taxpayer's mercantile business from its realty business "by means of a sale of some of the assets of the corporation to the stockholders in exchange for the capital stock." Taxpayer's secretary and attorney, Kirby,[2] was authorized to draft a resolution concerning the plan and to prepare for its execution. (R. 262.)

At that time, taxpayer had authorized an outstanding 20,000 shares of common stock having a par value of $10 per share so that its stated capital was $200,000. (R. 259, 273.) Of this stock, McEnery owned 6,236 shares (about 31%) and Robert F. Benson owned 8,017 shares (about 40%). Together, Ben-

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[1] The testimony of McEnery, taxpayer's president at the time involved, indicated that tax considerations prevented the performance of that plan. (R. 65.)

[2] Kirby was also a member of the board of directors. (R. 259.)

son and McEnery held approximately 71% of the taxpayer's outstanding stock. The remaining shares were held by 132 persons, most of whom held stock in small lots from three to one hundred shares. (R. 259–260.)

At a special meeting of the directors on May 22, 1951, a resolution was adopted approving a plan whereby taxpayer would offer to its shareholders the opportunity to exchange for 8,000 shares of taxpayer's stock all of the assets used in and constituting its mercantile business. The plan further provided that if the exchange were executed, the taxpayer would give a 20-year lease to the transferees of the ground floor of the building at an annual rent of $18,000. (R. 262.)

A special meeting of the stockholders was held on June 7, 1951. The minutes of that meeting state in part as follows (R. 263):

> The President announced that the sole purpose for the meeting was the discussion of the proposed method of partial liquidation of the corporation's assets by distributing the merchandising business to stockholders in exchange for 8,000 shares of stock.

Under the plan, a shareholder would receive a 1/8000 interest in the mercantile business for each share of stock surrendered. (R. 268.)

The stockholders approved the plan by a resolution which stated that the purpose was "to effect a division and segregation of the operation, management and maintenance of the real properties of the corporation from the ownership, operation, management

and control of the merchandising business of the corporation." (R. 263.)

Pursuant to the execution of the plan, an escrow agent was selected to receive stock from those who elected to surrender their shares. An escrow account was opened on July 2, 1951. (R. 265.) This escrow continued until October, 1951, when the distribution of the mercantile business was made and the lease of taxpayer's property was executed. While the escrow was pending, McEnery and Benson acquired more shares of stock raising their total holdings to 6,963 shares (34.3%) and 8,231 shares (41.1%), respectively, giving them a combined holding of 75.4% of the outstanding stock. (R. 266, 268–269.)

McEnery testified that during the life of the escrow account, stockholders would deposit shares and then change their minds and remove them, and other shareholders would deposit shares to take the place of those removed. The stock in escrow was thus in a state of flux. (R. 83, 86.) The flux continued until about October 1, 1951, at which time there remained seven shareholders who had elected to surrender all or part of their stock.[3] On October 19, 1951, these seven persons executed an agreement forming a partnership to operate the hardware business. The hardware business was not transferred from taxpayer to the partnership until after the execution of that agreement. (R. 266, 268–269.)

After the partnership was formed, it executed a 20-year lease of the ground floor of taxpayer's build-

[3] Four members of this group surrendered all of their stock and the other three surrendered only part. (R. 266.)

ing at an annual rent of $18,000. Under the escrow agent's instructions from Kirby, taxpayer's attorney and secretary, the hardware business could not be turned over to the partnership until (1) the lease had been executed and recorded, (2) taxpayer had received $18,000 representing the rent for the last year on the lease, and (3) the 8,000 shares of stock were received. This was performed by October 24, 1951, and on that date, the escrow agent delivered a bill of sale to the partnership.[4] (R. 268.)

Benson and McEnery were members of that partnership and surrendered 3,753 and 3,754 shares respectively. Thus, their combined interests accounted for more than 93% of the partnership. Also, they retained 4,478 and 3,209 shares respectively, amounting to 64% of taxpayer's outstanding stock. (R. 266–267.)

At the regular meeting of the board of directors on August 16, 1961, taxpayer's accountant noted that in a submitted financial statement, he had reduced the stated capital of taxpayer from $200,000 to $120,000. The directors accordingly adopted a resolution reducing taxpayer's stated capital to $120,000 represented by 12,000 shares of stock at $10 par. This was expressly ratified by the shareholders at their annual meeting on February 13, 1952. (R. 273.) Thus, the surrendered stock was retired. (R. 290.)

In its return for 1951, taxpayer treated this transaction as a sale and reported a loss of $226,349.84 therefrom. It computed this loss by deducting from

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[4] The bill of sale was dated October 19, 1951, but was not even delivered to the escrow agent until October 23. (R. 271.)

the adjusted basis of the transferred assets ($306,-349.84) the par value of the 8,000 shares of surrendered stock ($80,000). (R. 278.) Taxpayer reported a total loss of $246,952.11 in that year.[5] In its returns for 1952 and 1953, taxpayer reported net income of $16,544.54 and $26,982.20, respectively, which it claimed was discharged by carrying over the net operating loss from 1951. The Commissioner determined that taxpayer had no recognizable loss in 1951 and therefore disallowed the claimed carry-over deducation. (R. 276.) In addition, the Commissioner determined that taxpayer had a net profit rather than a loss in 1951. (R. 277.)

In connection with the transaction, taxpayer expended $450 in 1951 and $1,650.50 in 1952 for legal and accounting fees. Taxpayer deducted those items as business expenses and the Commissioner disallowed them on the ground that they were nondeductible capital expenses. (R. 275.)

Taxpayer brought this action for a redetermination of the Commissioner's decision concerning the distribution of the mercantile business to the partnership and the expenditures for legal and accounting fees.[6] The Tax Court sustained the Commissioner on both issues. (R. 254–295.)

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[5] Of that amount, $217,527.20 was represented as a loss from sales. (R. 275.)

[6] There were originally two other issues in this case, but they were conceded below, one by taxpayer and one by the Commissioner.

SUMMARY OF ARGUMENT

1. Taxpayer contends that it had a net loss deduction in 1951 with a resulting carry-over for subsequent years. This loss allegedly arose as a result of a distribution of taxpayer's mercantile business in exchange for 8,000 shares of its capital stock. While a sale of assets by a corporation for its own stock is a taxable transaction to it, a partial liquidation is not. Whether a distribution in kind is a sale or a liquidation is a question of fact turning upon the particular circumstances of the case. In this case, the court below found that the distribution in kind with the resulting contraction of taxpayer's business was a partial liquidation and, therefore, no gain or loss could be realized by the taxpayer therefrom. That finding is supported by substantial evidence.

Moreover, even if the transaction were a sale, taxpayer did not realize a loss therefrom. The distribution in kind was made to a partnership, two members of which controlled 64 per cent of the taxpayer's outstanding stock. Under the constructive ownership provisions of Section 24(b)(2) of the Internal Revenue Code of 1939, each member of the partnership is deemed to own over 50 per cent of the taxpayer's stock and, therefore, Section 24(b)(1) prohibits the recognition of loss in this transaction.

Also, taxpayer failed to demonstrate the fair market value of the shares of stock that were surrendered in exchange for the mercantile business. It merely valued them at par. Taxpayer, therefore, failed to meet its burden of proof on that question.

2. Taxpayer also contends that expenditures for certain legal and accounting expenses incident to the transaction here involved were improperly disallowed by the court below as capital expenses. As taxpayer indicated, the resolution of this issue was consistent with the court's determination that the distribution of the mercantile business was a partial liquidation rather than a sale.

ARGUMENT

I. The distribution of taxpayer's mercantile business in exchange for capital stock was a partial liquidation rather than a sale and, therefore, no gain or loss was realized thereby

In October, 1951, taxpayer transferred the assets of its mercantile business to a partnership in return for 8,000 shares of its capital stock. (R. 268–269.) Taxpayer treated the transaction as a sale on its federal tax returns and reported a loss therefrom of $226,-349.84. Taxpayer computed this loss by deducting the par value of the transferred stock ($80,000) from the adjusted basis of the assets given in exchange ($306,349.84). (R. 278.)

Treasury Regulations 111 (1939 Code), Section 29.22(a)–15 (Appendix, *infra*), provide that where a corporation acquires its own shares as consideration for the sale of assets, the resulting gain or loss is recognized. However, Section 29.22(a)–20 (Appendix, *infra*) provides that "No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however, they may have appreciated or depreciated in value since their acquisition." See, *Dill Manufacturing Co.* v. *Commissioner,* 39 B.T.A. 1023. The ques-

tion of whether an exchange of a corporation's assets for its stock is a sale or a partial liquidation "depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances." Treasury Regulations 111 (1939 Code), Sec. 29.22(a)–15. See, *Commissioner* v. *S. A. Woods Mach. Co.,* 57 F. 2d 635, 636 (C.A. 1st), reversing, 21 B.T.A. 818, certiorari denied, 287 U.S. 613.

Thus, the primary issue in this action (*viz.,* whether the exchange of the mercantile business for the capital stock was a partial liquidation rather than a sale) is a factual question. Cf., *Earle* v. *Woodlaw,* 245 F. 2d 119, 126 (C.A. 9th), certiorari denied, 354 U.S. 942. The Tax Court found that the transaction was a partial liquidation and, consequently, that taxpayer did not realize a loss therefrom. As we now show, that finding is amply supported by the evidence and, therefore, is unassailable on review, *Commissioner* v. *Court Holding Co.,* 324 U.S. 331, 333–334; *Helvering* v. *Rankin,* 295 U.S. 123, 131; *Commissioner* v. *Duberstein,* 363 U.S. 278, 291; *Grace Bros.* v. *Commissioner,* 173 F. 2d 170, 173–174 (C.A. 9th).

A. The evidence supports the decision of the Tax Court

The purpose of the distribution in kind here involved was to segregate the mercantile business from the real property business. (R. 263.) Taxpayer's officers had first considered selling the mercantile business but never executed that plan. In 1950, taxpayer's directors proposed that the segregation be effected by a corporate "spin-off"—i.e., by forming a new corporation and transferring the real estate business thereto in exchange for stock which was to be dis-

tributed to taxpayer's shareholders. That plan was also abandoned, apparently for tax reasons. (R. 65, 260–262.)

Finally, in May, 1951, taxpayer's president, McEnery, suggested to the directors the plan that was ultimately adopted and is here involved. McEnery first described that plan as "a sale of some of the assets of the corporation to the stockholders in exchange for the capital stock." (R. 262.) However, McEnery later described it at a subsequent stockholders meeting as a "*partial liquidation* of the corporation's assets by distributing the merchandising business to stockholders in exchange for 8,000 shares of stock." [Emphasis added.] (R. 263.) Also, the shareholders adopted a resolution at that meeting approving the proposed plan in terms which indicate that a purchase-sale transaction was not contemplated. (R. 289.)

At the trial, McEnery was asked why the number of shares to be surrendered was fixed at the figure 8,000. McEnery testified that the mercantile business was worth two-fifths of the corporation's total business and that the real estate business was worth three-fifths. The number of shares to be surrendered was therefore fixed at 8,000, i.e., two-fifths of the outstanding capital stock, which was then 20,000 shares. (R. 109–110.) In other words, taxpayer exchanged two-fifths in value of its assets for two-fifths of its outstanding stock.[7]

[7] The following colloquy, which occurred during the cross-examination of McEnery, dispels any doubt concerning the equality of the exchange (R. 109–110) :

The result and purpose of the transaction was to contract the business of taxpayer by eliminating its mercantile activities. Contraction of business is one of the basic elements of a partial liquidation. E.g., *Earle* v. *Woodlaw,* 245 F. 2d 119, 126 (C.A. 9th), certiorari denied, 354 U.S. 942; *Pacific Vegetable Oil Corp.* v. *Commissioner,* 251 F. 2d 682, 685 (C.A. 9th); *Imler* v. *Commissioner,* 11 T.C. 836, 841. Indeed, in *Weinman* v. *Commissioner,* decided October 15, 1956 (1956 P–H T.C. Memorandum Decisions, par. 56,229), the Tax Court indicated that contraction is the very essence of a partial liquidation. The court said:

> Without more, it would seem that a business, which for adequate reasons eliminates part of its operations and in the process rids itself of

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"Q. How did you arrive at this figure of 8,000 shares?

"A. I didn't arrive at that. It was arrived at by various discussions, and so forth, with the accountant, as to what would be somewheres near an equal apportionment. That was me, with the accountant.

"The Court. Well, you still haven't answered the question. What we want to know is: Why did you conclude that 8,000 shares would be the number of shares to be surrendered in exchange for the inventory of the mercantile business?

"The Witness. I think if you put the mercantile business at anywheres near the value it should have been and put the real estate at anywheres near the value it should have been, it should be about three-fifths to two-fifths.

"The Court. Which?

"The Witness. Two-fifths for the business and three-fifths for the real estate.

"Q. (by Mr. Munter). In what you had attempted to work out in this 8,000 to 12,000——

"The Court. 8,000 is supposed to be two-fifths of 20,000, is that the idea?

"The Witness. Yes, Ma'am."

> property no longer useful in those operations, has engaged in a partial liquidation in the most direct sense.

The term "partial liquidation" is defined in Section 346 of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 346). In discussing that section prior to its enactment, the Senate Report (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4899)) stated:

> Primarily, this definition involves the concept of "corporate contraction" *as developed under existing law.* * * *.
>
> It is intended that a genuine contraction of business *as under present law* will result in partial liquidation. [Emphasis added.]

After the distribution of the mercantile business with the resulting contraction of taxpayer's business, the stated capital of taxpayer was reduced from $200,000, represented by 20,000 shares of stock at $10 par, to $120,000 represented by 12,000 shares. (R. 273.) Thus, the 8,000 shares which had been redeemed from the partnership were retired and were no longer outstanding. (R. 290.)

Taxpayer apparently disputes this last finding (Br. 29) and contends that the 8,000 shares were not retired but were restored "to the status of authorized but unissued shares." It is noteworthy that in the court below, taxpayer asserted in its opinion brief (p. 14) that the shares were retired when the stated capital was reduced but repudiated that assertion in its reply brief (p. 6). In any case, the reduction of stated capital infers that the shares were retired.

In the absence of evidence to the contrary, the finding of the Tax Court on that question must, therefore, be sustained. E.g., *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 333–334; *Commissioner* v. *Duberstein*, 363 U.S. 278, 291.

Moreover, even if taxpayer were correct, the difference between retired stock and stock restored to the authorized but unissued status is not sufficient to alter the tax consequences of this transaction. In either event, the redemption of the shares with the resulting reduction of stated capital constituted a change in the capital structure of the business, and it is that change which is most significant here. Section 115(i) of the Internal Revenue Code of 1939 (Appendix, *infra*) defines a partial liquidation as a "distribution by a corporation in complete cancellation *or* redemption of a part of its stock" [emphasis added]. The statute requires either retirement or redemption, and those terms are not synonymous. The term "retirement" includes redemption but is a much broader term.[8] *McClain* v. *Commissioner*, 311 U.S. 527, 530. Consequently, it is not necessary that the stock be actually retired for a partial liquidation to exist. That is particularly true here where apparently California law makes no distinction between retired stock and stock which is restored to the status of authorized and unissued. See, Section 1714 of the California Corporations Code (Appendix, *infra*), which states that "Unless the articles provide other-

[8] The word "redeem" is defined in Webster's International Dictionary (2d ed.) as, *inter alia*, to repurchase or to regain possession by purchase.

wise, treasury shares may be retired and restored to the status of authorized and unissued shares."

After the distribution, the mercantile business was controlled by the same two persons (McEnery and Benson) who controlled taxpayer before that transaction. They owned more than 93% of the partnership and 64% of the taxpayer's outstanding stock. (R. 266–267.)

In sum, the emerging factual picture clearly points to a partial liquidation rather than a sale. The transaction here involved was executed in order to segregate taxpayer's mercantile business from its real estate business. It was necessary to distribute the mercantile business in exchange for stock because of the tax consequences then attendant to a corporate spin-off. As taxpayer's offices were acutely aware of possible tax consequences, they attempted to cloak the liquidation in the guise of a sale so that the corporation could realize a net loss deduction, part of which might be carried five years forward. Sec. 122, Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 122). However, the officers did not always adhere to the label they had attached to this transaction. In the minutes of the director's meeting of June 7, 1951, McEnery is quoted as describing the transaction as a partial liquidation. (R. 263.) Also, as the court below noted (R. 289–290), taxpayer apparently failed to comply with the Bulk Sales Act of California. The significance of this omission is that it lends further weight to the inference that

even taxpayer's officers and attorney did not consider this transaction as a sale.[9]

Of greater importance, however, is that the purpose and result of the distribution was a contraction of taxpayer's business. The taxpayer exchanged its mercantile business, representing two-fifths of its total corporate value, for 8,000 shares of stock (i.e., two-fifths of its stock). Taxpayer's business was contracted; its assets were reduced; its stated capital was reduced; and the surrendered stock was retired. The net effect of the transaction was that while the same two persons continued to control both the mercantile and the real estate business, the taxpayer's business had been contracted so that its realty holdings were no longer subject to the risk of the mercantile business, and the amount of stock redeemed was in exact proportion to the relative value of the assets distributed (i.e., two-fifths of the assets in exchange for two-fifths of the stock.)

Thus, there is substantial and convincing evidence to support the decision of the Tax Court which should, therefore, be sustained. E.g., *Commissioner* v. *Court Holding Co., supra;* and *Commissioner* v. *Duberstein, supra.*

B. The decision of the Tax Court is consistent with the cases which have considered the issue here involved

Taxpayer asserts (Br. 26–28) that the decision below is inconsistent with the decisions of several circuit

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[9] As taxpayer observed in its opening brief below (p. 16), its attorney at that time had a fine local reputation. It is unlikely, therefore, that he would have failed to comply with the Bulk Sales Act if he believed the transaction to be a sale.

court cases. For a proper consideration, these cases should be viewed in the perspective of the development of the case law pertaining to the tax consequences of a corporation's dealing in its own stock.

Prior to 1930, there was a split of authority as to whether a corporation could in any circumstances realize a gain or loss on the acquisition of its own common stock. 7 Mertens, Law of Federal Income Taxation (1957 ed.) Sec. 38.29. In that year, the entire court of the Board of Tax Appeals considered the matter and determined that no gain or loss was realized irrespective of whether the stock was acquired by purchase or redemption in liquidation. *Houston Brothers Co.* v. *Commissioner,* 21 B.T.A. 804. Two years later, the First Circuit held that a gain was recognized where a corporation purchased its own stock and, accordingly, reversed the decision of the Board of Tax Appeals to the contrary. *Commissioner* v. *S. A. Woods Mach. Co.,* 57 F. 2d 635, reversing 21 B.T.A. 818, certiorari denied, 287 U.S. 613. The court held that the taxpayer in that case was dealing in its own stock as it might in that of another company. The issue involved was whether a corporation could realize a gain in those circumstances, and no issue was raised or considered as to whether the transaction was a partial liquidation.

Also, in *Commissioner* v. *Boca Ceiga Development Co.,* 66 F. 2d 1004 (C.A. 3d), it was assumed that the transaction was a sale, and the question presented was whether a corporation's purchase of its stock could result in a taxable transaction to it. Again, there was no contention made that the transaction was

a liquidation. Similarly, see *Allyne-Zerk Co.* v. *Commissioner,* 83 F. 2d 525 (C.A. 6th); *Dorsey Co.* v. *Commissioner,* 76 F. 2d 339 (C.A. 5th), certiorari denied, 296 U.S. 589; and *Trinity Corp.* v. *Commissioner,* 127 F. 2d 604 (C.A. 5th), certiorari denied, 317 U.S. 651.

All of those cases turned upon the particular facts there involved and do not control this case. However, it is significant that the question of whether there was a partial liquidation was not argued or considered there. As the Supreme Court stated in *Webster* v. *Fall,* 266 U.S. 507, 511:

> The most that can be said is that the point was in the cases if anyone had seen fit to raise it. Questions which merely lurk in the record, neither brought to the attention of the court nor relied upon, are not to be considered as having been so decided as to constitute precedents.

The sole appellate decision cited by taxpayer which actually considered the question here involved was *Hammond Iron Co.* v. *Commissioner,* 122 F. 2d 4 (C.A. 5th). In that case, the corporation purchased the outstanding preferred and common shares of a stockholder and claimed a loss on the transaction. The Commissioner disallowed the deduction and contended in the notice of deficiency that the transaction was actually a partial liquidation. The Board of Tax Appeals decided for the Commissioner on a different ground. On review, the Commissioner did not urge that the transaction was a partial liquidation but argued only in support of the reasons given by the lower court.

The Fifth Circuit nevertheless passed upon that issue and held that the evidence did not indicate a liquidation. However, the evidence in this case does so indicate. It is noteworthy that in *Hammond Iron, Trinity Corp., Dorsey Co., Boca Ceiga,* and *Allyne-Zerk,* common stock was only a part of the consideration paid to the corporation for its assets. See also, *Johnson-McReynolds Chevrolet Corp.* v. *Commissioner,* 27 T.C. 300. The existence of additional consideration would indicate a sale. In the *S. A. Woods* case, the stock was accepted in settlement of liquidated damages and, consequently, there was no business contraction there. Those facts are in contrast with the facts of the instant case where only the taxpayer's stock was exchanged and there was a contraction of business.

On the other hand, there are numerous cases holding that such transactions are partial liquidations. E.g., *Lucius Pitkin, Inc.* v. *Commissioner,* 13 T.C. 547; *Fox* v. *Commissioner,* decided June 30, 1939 (1939 P–H B.T.A. Memorandum Decisions, par. 39,325), affirmed *per curium,* 113 F. 2d 113 (C.A. 3d); *Dill Manufacturing Co.* v. *Commissioner,* 39 B.T.A. 1023. While these cases are relevant, as the Regulations provide,[10] it is the particular factual circumstances of each case that control. As demonstrated in Point A above, the evidence in this case supports the decision below.

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[10] Treasury Regulations 111 (1939 Code) Sec. 29.22(a)–15. See also, *Commissioner* v. *S. A. Woods Mach. Co.*, *supra*, 57 F. 2d, p. 636.

II. The Tax Court properly determined that certain expenditures of taxpayer for legal and accounting services incident to the distribution in partial liquidation were capital expenses and, therefore, are not deductible

In connection with the transaction here involved, taxpayer expended $450 in 1951 and $1,650.50 in 1952 for legal and accounting services. (R. 275.) Taxpayer seeks deductions for those items as business expenses. As the expenditures were incurred pursuant to the execution of the plan of liquidation, the expenses must be capitalized and may not be deducted as ordinary expenses. *Mills Estate* v. *Commissioner,* 206 F. 2d 244 (C.A. 2d); *Standard Linen Service, Inc.* v. *Commissioner,* 33 T.C. 1, 17.

Taxpayer apparently concedes (Br. 38) that the decision of the court below on this issue is a proper consequence of the court's decision that the transaction was a liquidation. Taxpayer contends only that if this Court reverses the Tax Court and holds that the transaction was a sale, then the decision on this question should also be reversed. We agree with the taxpayer that the resolution of this question turns upon the resolution of the primary issue in this case.[11]

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[11] However, we note that while this question is closely interrelated with the primary issue on review, taxpayer did not mention it in its petition for review (R. 300–301) which taxpayer adopted as its statement of points to be urged on review. Consequently, the Court may wish to consider whether under its rules (Rule 17(6)) this question should be reviewed here. See, *Bank of America Nat. T. & Sav. Ass'n* v. *Commissioner*, 126 F. 2d 48, 52 (C.A. 9th).

III. Even if taxpayer's distribution of the mercantile business were a sale rather than a partial liquidation, taxpayer would nevertheless have no recognizable loss from the transaction

As previously stated, the primary issue on review is whether taxpayer's distribution of the mercantile business is a liquidation or a sale. The court below found and the Commissioner contends that it was a liquidation in which there can be no loss to the corporation. However, even if taxpayer were correct in asserting that the transaction was a sale, it would, nevertheless, have no recognizable loss therefrom.

A. No loss is allowable on this transaction because the distributees of taxpayer's mercantile business owned more than 50 percent of its outstanding stock

Section 24(b) of the Internal Revenue Code of 1939 (Appendix, *infra*), "prohibits any deduction, in computing net income, for losses from sales or exchanges of property—except in the case of distributions in liquidation—between an individual and a corporation whose stock is more than 50 percent owned by or for him." *Commissioner* v. *Whitney,* 169 F. 2d 562, 564, certiorari denied, 355 U.S. 892. This prohibition is equally applicable where the sale or exchange is between a corporation and a partnership whose members own together more than 50 per cent of the corporations outstanding stock. *Commissioner* v. *Whitney, supra.* Treasury Regulations 111 (1939 Code), Sec. 29.24–6(c) and (d) (Appendix, *infra*). That is so because of the provision for constructive ownership of stock in Section 24(b)(2) of the Code.

The mercantile business was not transferred by taxpayer until after the formation of the partnership[12] and was transferred to the partnership. (R. 269.) Two of the partners (McEnery and Benson) owned more than 50% of the outstanding stock of taxpayer after the distribution. (R. 267.) Those same two men owned more than 93% of the partnership. (R. 266.) By operation of the constructive ownership provisions in Section 24(b)(2), each of the seven partners is deemed to own more than 50% of the outstanding stock of taxpayer. Consequently, the mercantile business was transferred to persons owning

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[12] That finding is amply supported by the evidence. The escrow account was opened on July 2, 1951. (R. 265.) During the life of the escrow account, stockholders would deposit shares and then change their minds and remove them. The stock in escrow was thus in a state of flux. (R. 83, 86.) The flux continued until about October 1, 1951, at which time there remained seven shareholders who had elected to surrender stock. On October 19, 1951, those seven persons formed a partnership to operate the business. (R. 269.)

After the partnership was formed, it executed a 20-year lease of the ground floor of taxpayer's building for $18,000 per year. (R. 272.) The escrow agent was instructed by Kirby, taxpayer's attorney and secretary, not to turn over the mercantile business until: (1) the lease had been executed and recorded, (2) taxpayer had received $18,000 representing the rent for the last year on the lease, and (3) the 8,000 shares of stock were received. (R. 268.) It is clear that there could be no exchange until those conditions had been met. That occurred on October 24, 1951 (five days after the formation of the partnership) and on that date, the escrow agent delivered the bill of sale to the partnership. (R. 268.)

Also, it is noteworthy that the partnership agreement (Ex. 4–D) states that the parties thereto surrendered the 8,000 shares "concurrently with the execution of [the] partnership agreement."

more than 50% of taxpayer's stock, and no loss could be realized on the transaction. Sec. 24(b)(1) of the Internal Revenue Code of 1939. E.g., *Commissioner* v. *Whitney, supra.*

The Commissioner raised this question in the court below as an alternative contention. In view of the Tax Court's resolution of the primary issue here involved, the court considered it unnecessary to consider this question. (R. 293.)

B. Taxpayer failed to demonstrate that it suffered any actual loss on the transaction

Finally, taxpayer failed to demonstrate in the court below that, in fact, it suffered any loss on this transaction even if it were a sale. The amount of gain or loss on the purchase of stock is computed on the basis of the fair market value of the stock as compared with the adjusted basis of the assets. Cf., *Dorsey Co.* v. *Commissioner,* 76 F. 2d 339 (C.A. 5th), certiorari denied, 286 U.S. 589. Taxpayer had the burden of demonstrating the market value of the stock surrendered to it. See, *Burnet* v. *Houston,* 283 U.S. 223.

Taxpayer computed its alleged loss on the premise that the value of the stock was par, *viz.,* $10 per share.[13] (R. 278.) Thus, taxpayer contends that in transferring two-fifths of its assets for two-fifths of its own stock, it suffered a loss of over $226,000. (R.

[13] There is no evidence in the record to substantiate that evaluation. The sole testimony concerning the value of the stock was the statement of McEnery that he purchased "a few shares" during this period for "around * * * $15.00 a share." (R. 130.) Such testimony of only one transaction with one person concerning a few shares is hardly adequate to warrant a finding concerning the fair market value of the stock.

278.) In view of the obvious equality of value between the stock and the transferred assets, the contention that the stock was worth only $80,000 is palpably erroneous, and taxpayer failed to demonstrate any actual loss on the exchange.

C. No loss carry-over is allowable

The court below also held alternatively that even if taxpayer sustained a loss on a sale, there could be no carry-over to subsequent years. (R. 286.) See, *Dalton* v. *Bowers,* 287 U.S. 404; *Libson Shops* v. *Koehler,* 353 U.S. 382. As the transaction involved was not a sale and even if it were taxpayer did not realize a loss therefrom, it is not necessary for the Court to reach this question.

CONCLUSION

For the foregoing reasons, we respectfully submit that the decision of the Tax Court should be affirmed.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

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(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

* * * * *

(b) *Losses from Sales or Exchanges of Property.*—

(1) *Losses disallowed.*—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2)(D);

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of

the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(D) Between a grantor and a fiduciary of any trust;

(E) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or

(F) Between a fiduciary of a trust and a beneficiary of such trust.

(2) *Stock ownership, family, and partnership rule.*—For the purposes of determining, in applying paragraph (1), the ownership of stock—

(A) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(B) An individual shall be considered as owning the stock owned directly or indirectly, by or for his family;

(C) An individual owning (otherwise than by the application of subparagraph (B)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(D) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(E) *Constructive ownership as actual ownership.*—Stock constructively owned by a person

by reason of the application of subparagraph (A) shall, for the purpose of applying subparagraph (A), (B), or (C), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of subparagraph (B) or (C) shall not be treated as owned by him for the purpose of again applying either of such subparagraphs in order to make another the constructive owner of such stock.

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(26 U.S.C. 1952 ed., Sec. 24.)

Sec. 115. Distribution by Corporations.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111 (1939 Code):

Sec. 29.22(a)–15. *Acquisition or Disposition by a Corporation of Its Own Capital Stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par of stated value of such stock.

But if a corporation deals in its own shares as it might in the shares of another corpora-

tion, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code.

SEC. 29.22(a)–20. *Gross Income of Corporation in Liquidation.*—When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. (See sections 274 and 298.) Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. But see section 44(d) and section 29.44–5. (See further section 29.52–2.)

SEC. 29.24–6. *Losses from Sales or Exchanges Between Certain Classes of Persons.*—* * *

(b) *Corporations (including shareholders).*—In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24(b)(1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual share-

holder (see section 24(b)(1)(B)) or between two corporations (see section 24(b)(1)(C)). Under section 24(b)(1)(B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. * * *

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(d) *Illustrations of the application of section 24(b).*—The application of section 24(b) may be illustrated by the following examples:

* * * * *

Example (2). On June 15, 1942, all of the stock of the N Corporation was owned in equal proportions by A and A's partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1942, between A and the N Corporation or AP and the N Corporation inasmuch as, by the application of section 24(b)(2)(C), each partner is considered as having owned the stock owned by the other and, therefore, is considered as having owned more than 50 percent in value of the outstanding stock of the N Corporation. Deductions for losses from sales or exchanges between A's brother, AB, and the N Corporation, or between AP and A, or AP and AB are not prohibited by section 24(b).

California Corporations Code, 24 West's Annotated California Codes:

§ 1714. *Treasury shares.* Treasury shares shall not carry voting or dividend rights and shall not be counted as outstanding shares for any purpose, nor as assets for the purpose of computing a surplus available for dividends or the purchase of shares issued by the corporation or the making of any other distributions to its shareholders. Unless the articles provide other-

wise, treasury shares may be retired and restored to the status of authorized and unissued shares without reduction of stated capital or may be disposed of for such consideration as the board of directors may fix. If the shares are reissued, the amount of the proceeds shall be attributed to paid-in surplus insofar as an excess of net assets over the amount of stated capital results therefrom.

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